DE FACTO CORPORATIONS.

THE formation of corporations solely by the mutual agreement of the members is prohibited by the common law. In the American states to-day corporations are organized almost exclusively under general incorporation laws authorizing their formation. If the requirements prescribed by the statute are not observed there are three conceivable alternatives open to the courts. First, they may place the resulting association on the same basis as those which have fully complied with the law. Second, they may refuse to recognize the existence of the association and consider all its acts null and void. Third, they may take a middle ground and give the corporation a qualified recognition.

To adopt the first alternative in some cases would violate the common-law prohibition upon the formation of corporations by private contract and nullify the statutes of incorporation. The courts have, therefore, not found this first alternative a good rule to apply in all cases. But where the above-mentioned objections do not obtain they have adopted this alternative and have treated the corporation, though not organized in the manner outlined by statute, as a corporation *de jure*. The courts do this, for example, where the provisions of the statute have not been literally complied with, but have been substantially followed,[1] or even where the provisions of the statute have not been followed at all if the provisions are merely directory or constitute conditions subsequent to incorporation.[2]

To adopt the second alternative and deny existence to a corporation existing in fact and refuse to give validity to any of its acts would be illogical and frequently work injustice, so the courts have used this alternative only where there has been no, or very little, compliance with the statute.

Where the corporation has fallen a little short of substantial compliance, the courts have adopted the third alternative and have recognized the legal existence of the corporation for most purposes.

[1] 20 HARV. L. REV. 467, note 16; Machen, Modern Law of Corporations, § 264.

[2] 20 HARV. L. REV. 467, notes 17 and 18; Machen, Modern Law of Corporations, § 264.

If "the associates have made an attempt to incorporate resulting in a colorable corporate organization; [under] a law authorizing the formation of such a corporation as was attempted; [and] there had been use of some of the powers which such a corporation would possess; [and] the persons seeking to prevent collateral attack [have] acted in good faith," a *de facto* corporation is created.[3]

The state may annul its charter for failing to comply with the statute, but no one else can take advantage of its defective incorporation to increase his own rights or vary the obligations of the corporation's stockholders. The American decisions are authority for the proposition that a corporation *de facto*, as defined above, is equivalent to a corporation *de jure* except for those legal consequences which necessarily result from the possibility of the *de facto* corporation having its existence forfeited by the state for failing to comply with the statute under which it was organized. This is the *de facto* doctrine. To the broad statement that the *de facto* corporation is just as good as the *de jure* corporation except as against the state, there are two well-known classes of cases which are exceptions. These classes of cases, for the purposes of brevity, may be designated as the eminent-domain and the stock-subscription cases. These cases, while they are exceptions to the broad statement made above, are not, as will be shown later, exceptions to the *de facto* doctrine. In fact there are very few, if any, defensible American decisions, involving the question, which cannot be explained by an unqualified application of the *de facto* doctrine.[4]

In spite of the vast array of authority to the contrary, it is still contended in numerous *dicta*[5] by the courts and in the occasional *ipsi dixit* of legal theorists that there is no distinct doctrine of *de facto* corporations. They admit the doctrine is applied but not that it has ever had an independent application. It cannot stand on its

[3] 20 HARV. L. REV. 464.

[4] "Cases not seldom arise in which some condition precedent to the legal organization of a corporation has been omitted, and in which no conclusive certificate of due incorporation exists, and in which no estoppel to deny the company's existence can be invoked. In such cases, the American courts generally will, under certain conditions, hold that the association although not legally incorporated is nevertheless a corporation *de facto*, that is to say, an association whose right to corporate functions and attributes is complete as against all the world except the sovereign." Machen, Modern Law of Corporations, § 284.

[5] Slocum *v.* Providence Steam & Gas Pipe Co., 10 R. I. 112, 114 (1871). 1 Machen, Modern Law of Corporations, 242, note 1, cites cases.

own legs, they say, but must be propped up by other theories. Its sole application is made in conjunction with "extenuating circumstances."[6] As there is regularly no refusal by the courts to apply the *de facto* doctrine wherever a *de facto* corporation exists, the zealous advocates of restriction have busily occupied themselves in the search for "extenuating circumstances" as the basis for invoking the doctrine. They find the doctrine of *de facto* corporations applied where there has been dealing on a corporate basis. Dealing on a corporate basis then becomes the "extenuating circumstance" warranting an application of the doctrine. In such cases they say not only that the *de facto* corporation, but also the one who dealt with it, is conclusively estopped from asserting defectiveness in the incorporation of the company. But dealing on a corporate basis is not an "extenuating circumstance" found in all the cases where the *de facto* doctrine is applied. For example, one who has taken title to land from a *de facto* corporation may eject a stranger to that title from possession of the land.[7] An opponent of the *de facto* doctrine finds an "extenuating circumstance" justifying an extension of the doctrine to cases such as that just alluded to in the fact that relief is sought by a "third person." The doctrine of *de facto* public officers, he observes, affords relief to "third persons," but never to the public officers themselves. To his mind the application of the doctrine of *de facto* corporations for the benefit of "third persons" and for the denial of relief to the associates is analogous.[8]

Furthermore, the "extenuating circumstances" of dealing on a corporate basis and the "third person" seeking relief do not include or explain all the cases where the *de facto* doctrine is applied. The *de facto* corporation, itself, is frequently given relief where there has been no dealing on a corporate basis, and therefore in cases where, admittedly, the elements of estoppel are not present. Thus the *de facto* corporation may maintain ejectment against a stranger to the title or an action of tort against a trespasser.[9] The resources of these adversaries of the doctrine are again taxed, and they come

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[6] Professor E. H. Warren, *De Facto* Corporations, 20 HARV. L. REV. 456.

[7] Finch *v.* Ullman, 105 Mo. 255, 16 S. W. 863 (1891). For other cases holding that the *de facto* corporation may be a conduit of title see 20 HARV. L. REV. 457, note 2.

[8] Professor Warren, *De Facto* Corporations, 20 HARV. L. REV. 458.

[9] See cases cited in 20 HARV. L. REV. 471, note 24.

forth with the suggestion of another "extenuating circumstance." To explain such cases, they say if the associates are asserting a right in the name of the corporation which they would be entitled to assert in some form, they should be allowed to assert it as an artificial person.[10] There are two obvious faults to be found with this suggestion: It would apply as well to an association which had not met the requirements of the *de facto* doctrine as to the *de facto* corporation, but the courts do not give such an association relief;[11] and to give such association relief in its artificial name would run counter to well-established precedent in partnership law.[12]

But there are still other cases where the *de facto* doctrine is applied, and for which these opponents of the doctrine have not yet suggested an "extenuating circumstance" to warrant its application. "Under a statute punishing criminally embezzlement from an 'incorporated company' a conviction may be sustained if the company is a corporation *de facto*."[13] Numerous other instances of the doctrine's application may be cited,[14] but enough has been said to show that there is still need for ingenuity in suggesting further "extenuating circumstances."

Since the American decisions involving the *de facto* doctrine are uniformly explainable by an application of that doctrine alone, the query naturally suggests itself whether a search in each instance for "extenuating circumstances" as a basis for invoking the doctrine is not, after all, superfluous labor?

The arguments used to show that the doctrine is and should be restricted in its application may be grouped under four heads. 1. Judicial legislation. 2. The analogy of the doctrine of *de facto* public officers. 3. Estoppel. 4. The eminent-domain and stock-subscription cases. A very exhaustive and cogent presentation

[10] 20 HARV. L. REV. 470.

[11] Jones *v.* Aspen Hardware Co., 21 Colo. 263, 40 Pac. 457 (1895). See cases cited in Cook, Corporations, 6 ed., 1818, note 1.

[12] Parties cannot sue in the firm name but must sue collectively as individuals in the absence of statute. Mechem, Elements of Partnership, § 225.

[13] People *v.* Carter, 122 Mich. 668, 81 N. W. 924 (1900). The statement is quoted from Machen, Modern Law of Corporations, § 292.

[14] A corporation *de facto* cannot be wound up as a partnership. Its dissolution is governed by the same principles as the dissolution of a *de jure* corporation. A statute applicable to unincorporated companies does not apply to *de facto* corporations. See cases cited in Machen, Modern Law of Corporations, § 292.

of these arguments against the unlimited application of the doctrine of *de facto* corporations, the fullest the writer has met with, is made in an article on *De Facto* Corporations by Professor E. H. Warren in volume 20 of this Review. It will be sufficient for the purpose of this paper, which is to show that these arguments are unsubstantial, to confine our discussion almost wholly to his statement of them.

1. *Judicial legislation.*

The argument that the doctrine of *de facto* corporations is judicial legislation, Mr. Warren states substantially in this way. It is not for the courts to create a corporation. The franchise to be a corporation can be granted only by the legislature. The legislature has prescribed certain conditions precedent to incorporation, and if these are not fulfilled the resulting organization is not a corporation authorized by the legislature. If its existence is legally recognized by the courts, it is a creation of the courts, not of the legislature.[15]

It must be observed that this statement of the argument of judicial legislation goes against the whole doctrine of *de facto* corporations and not merely against applications of it in particular instances. Mr. Warren admits this, but he thinks the doctrine should be applied wherever the existence of "extenuating circumstances" warrant it, but not in the absence of such "extenuating circumstances." In order to make the argument of judicial legislation favor a restricted application of the *de facto* doctrine Mr. Warren's contention, novel as it is, amounts to this. The courts should deliberately "take to themselves powers belonging to the legislature" whenever they think the considerations for so doing are sufficiently urgent, but they should in each case use great care in determining whether the encroachment will be proper.[16]

Where a doctrine is presented to a court for the first time the argument that its adoption will constitute judicial legislation, if sound, is of the greatest weight, for clearly no court should consciously usurp legislative functions. But after such a doctrine has become established law the courts are not exercising a legislative power in applying the doctrine to the cases that come before them.

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[15] 20 HARV. L. REV. 468, 469.

[16] *Ibid.* 469.

They are merely applying the law. Since the doctrine of *de facto* corporations is now well-established law in the American states, it would seem that the argument that a court is invading the domain of the legislature in applying the doctrine, even if originally true, no longer obtains.

But in establishing the doctrine of *de facto* corporations originally is it so clear that the courts were legislating? We cannot agree with Mr. Warren that the right to act as a corporation is a franchise,[17] and therefore a right to be granted only by the legislature. The corporation, looked at fundamentally, is rather an association formed by the mutual agreement of its members, which the common-law principle of freedom of contract would permit to be formed by contract alone. The common-law prohibition upon the formation of corporations by private contract is a limitation upon freedom of contract based upon public policy. The privilege of doing business exempt from individual liability opened the door to imposition and fraud. Without this possibility of unfairness there is no objection to corporations being formed by contract without other formalities.[18] The chief purpose of incorporation laws

[17] "When individuals may incorporate themselves by these simple means, the notion that the right to be a corporation is a franchise is manifestly baseless. The right was formerly a franchise, when it could be secured only by the special favor of the crown or of the legislature. But a franchise is a special privilege, and any right that can be obtained by anybody merely by going through a few statutory forms cannot properly be designated by that term. As well might it be said that the right to make a conveyance of real estate is a franchise because the deed must be signed and sealed by the grantor with certain formalities and recorded in the registry of deeds. The requirements for the formation of a corporation are scarcely less simple. More than twenty years ago, Mr. Morawetz with his accustomed accuracy and insight said, 'The right of forming a corporation and of acting in a corporate capacity, under the general incorporation laws, can be called a "franchise" only in the sense in which the right of forming a limited partnership or of executing a conveyance of land by deed can be called a franchise.'" Machen, Modern Law of Corporations, § 19.

[18] "The only argument against leaving the exercise of corporate power entirely unrestricted by law is the argument of public policy. It may be said that the non-responsibility of the individual shareholders for corporate acts and liabilities would be productive of fraud and imposition; for persons dealing with a self-constituted corporation would have no means of knowing its capital and its constitution, and yet could not have recourse against the individual members, as in case of a copartnership. The objection here stated might, however, be remedied by requiring due notice of the corporate organization to be given to the world. And this seems to be the chief office of the general incorporation laws which are now in force nearly everywhere. To a great extent they repeal the prohibition of the common law, and leave the right of forming a corporation and of acting in a corporate capacity free to all, subject merely to

is not to prohibit the formation of corporations in ways not provided for by statute, but to point out a way to remove this objection of public policy upon which the common-law prohibition is based.[19] Where the objection is removed, no reason is left for maintaining the prohibition. Substantial compliance with the statute, the courts say, removes the objection, and no one is heard to object because the prohibition is not enforced. But in many cases the objection is removed without a substantial compliance, and in such cases why should not the prohibition likewise disappear?[20] The American courts have come to the conclusion that satisfaction of the requisites of the *de facto* doctrine not only removes the basis for objecting on any ground of public policy, but raises an urgent consideration of public policy against refusing to recognize the legal existence of the corporate entity.[21] It prevents annulment of the acts of a corporation on the ground of a technical flaw in the incorporation proceedings. In establishing the *de facto* doctrine, then, it seems the courts were neither making nor annulling legislative enactments, but following their common practice of adapting the common law to changed conditions.

such limitations and safeguards as are required for the protection of the public." Morawetz, Private Corporations, §§ 652, 744.

"No sufficient sound economic reason applicable to modern conditions can be adduced to support this common-law doctrine. For, in a free commercial country, individuals should have the power by mere private contract or agreement to associate themselves together as a corporation for any merely private lawful object. They should enjoy the same freedom in the formation of corporations that Anglo-Saxon jurisprudence has always accorded in the formation of partnerships or voluntary associations. To be sure, safeguards should be provided against fraud, and particularly against abuse of that immunity from individual liability of the members for the debts of the company which in popular estimation constitutes the most valuable, if not the most essential, characteristic of a commercial corporation. But subject to all needful restrictions of this sort, the organization of corporations in any country that prides itself on freedom of contract and on the right of its citizens to coöperate in the most effective manner in any lawful enterprise, should be as free as the formation of unincorporated associations." Machen, Modern Law of Corporations, § 1.

[19] It is true there are some statutory prohibitions which are merely declaratory of the common law, but these should be given no greater effect than the common law. Morawetz, Private Corporations, § 658.

[20] "Inasmuch as the prohibition of the common law against the unauthorized exercise of corporate power is based upon grounds of public policy alone, it seems but reasonable that the effect of this prohibition upon the legal validity of corporate acts should be determined by the requirements of public policy." Morawetz, Private Corporations, § 653.

[21] Machen, Modern Law of Corporations, §§ 284, 291; 20 HARV. L. REV. 457, 465–466.

2. *The analogy of de facto public officers.*

"Urgent considerations of public policy," Mr. Warren says, "have justified courts in giving for the benefit of a person dealing in good faith with a *de facto* officer the same effect to his acts as would be given to the acts of a *de jure* officer." The doctrine of *de facto* public officers is applied for the benefit of "third persons," but does not afford a remedy to the officers themselves. Mr. Warren concludes that to follow the analogy in corporation law would result in a doctrine of *de facto* corporations applied for the benefit of "third persons" but not for the benefit of the corporation. He even goes so far as to admit that a doctrine of *de facto* corporations for the benefit of "third persons" has found a place in the law, but contends that there is no such thing as a distinct doctrine of *de facto* corporations applicable for the benefit of the associates.

It is submitted, however, that the analogy of *de facto* public officers, instead of supporting Mr. Warren's contention, either is an argument against the whole doctrine of *de facto* corporations whether applied for the benefit of "third persons" or of the associates, or else it is an argument in support of the doctrine applied without distinction for the benefit of shareholders or third persons. If we look upon the corporation and the associates as identical, as Mr. Warren does in his treatment of the analogy, we must observe that the doctrine of *de facto* public officers does not extend beyond giving validity to the relations established between others, and has nothing to do with the relation existing between the officer and the persons dealing with him,[22] whereas the doctrine of *de facto* corporations consists in giving effect to the relation created between the corporation and others. On the other hand, if we proceed more in harmony with a fundamental conception of corporation law and treat the corporation as an entity distinct from the shareholders, the analogy of *de facto* public officers becomes an argument for the unlimited application of the doctrine of *de facto* corporations. The corporation being distinct from the natural persons of which it is composed, brings into existence relations between outsiders. It is true that the doctrine is nominally applied in favor of the cor-

[22] The doctrine of *de facto* public officers gives no remedy to the officers. 20 HARV. L. REV. 458, notes 4 and 5. The one dealing with the officer has no need for the doctrine, as he can rely on the principle of estoppel to protect him.

poration, but substantially its application is for the benefit of innocent shareholders.[23]

3. *The argument from estoppel.*

It is the law in the American states that one who has dealt with a corporation *de facto* as a corporation is precluded from taking advantage of the corporation's defective organization. Clearly the doctrine of *de facto* corporations is an easy and adequate explanation for these cases; but some courts in reaching their decisions have given as their reason for so doing "that a contract with a party as a corporation estops the party so contracting to deny the existence of the corporation."[24] It is perhaps true that in many cases where such language is used the courts were proceeding "upon a rule of evidence rather than the strict doctrine of estoppel. They have treated the contract with a party by a name implying a corporation, really as evidence of the existence of a corporation more than as an estoppel to disprove such fact."[25] No criticism is offered to such cases in their recognition of this rule of evidence; but the idea that a *de facto* corporation is based upon estoppel is confusing and without foundation. In fact, most of the courts of this country which have held to a strict estoppel of one who has dealt with the corporation have not confused the doctrine of estoppel and *de facto* corporations, but in such cases take the position that estoppel and *de facto* incorporation must concur in order to prevent inquiry into the corporation's existence.[26]

We may have a case in which estoppel *in pais* is to be applied against an individual stockholder or a corporation, but it is a reversal of the usual order of things to apply estoppel against one who has contracted with a corporation to preclude him from denying its *de*

[23] "Note, however, that the doctrine of *de facto* corporations applies in favor of the supposed corporation itself, whereas the doctrine of *de facto* officers does not apply in favor of the officer himself. A reason for this distinction may be found in the fact that the *de facto* corporation is composed of natural persons who may be regarded as innocent third persons, so that when the *de facto* doctrine is applied nominally in favor of the corporation itself it is substantially applied in favor of innocent shareholders." Machen, Modern Law of Corporations, § 284, note 2.

[24] Slocum *v.* Providence Steam & Gas Pipe Co., 10 R. I. 112 (1871).

[25] Stoutimore *v.* Clark, 70 Mo. 471 (1879); Jones *v.* Cincinnati Type Foundry Co., 14 Ind. 89 (1860).

[26] See cases cited in note 1, *supra*; 1 Machen, Modern Law of Corporations, 242; *ibid.* 238, note 4.

jure existence. If a corporation induces A. to enter into a contract with it upon its representation that it is a corporation competent to contract, there would be a clear case for applying the equitable doctrine of estoppel against the corporation and in favor of A. But under the above-stated facts, to apply estoppel against A. and in favor of the corporation is clearly not defensible upon any equitable grounds.[27]

Mr. Warren points out that the courts are not dealing with ordinary equitable estoppel. He says, "that the one who dealt with the corporation" never represented that the associates were a corporation; "he simply acted on their representation." He calls the principle "the argument *ad hominem*," which he states in this convincing way:

"The associates expected to be shielded, by their possession of the corporate privilege, against unlimited liability for a breach of the contract, and A. [the one who dealt with the corporation] may fairly be charged with knowledge of this. In consenting to contract with them as a corporation, he has, by necessary inference consented to avail himself on a breach of contract of only such remedies as could be used if the associates possessed the corporate privilege."[28]

The error in this statement arises from making the statement cover two situations which should be kept entirely distinct. In this statement Mr. Warren has covered the case where A. seeks to hold the stockholders individually liable upon the contract he entered into with the corporation and the case where the defectively organized corporation seeks to hold A. on his contract with it. In the first case it is true that the associates expected to be shielded against unlimited liability and that A. may fairly be charged with notice

[27] "But many American courts — perhaps we should say, most American courts — go further and hold not only that those who participate in representing to the public that a defectively incorporated company of which they are members is a legally constituted corporation are estopped to deny its corporate character, but also that anybody who deals with them as a corporation is likewise estopped. . . . This conclusion, it is submitted, cannot be justified by the ordinary principles of estoppel *in pais*. For the person or persons in whose favor the estoppel is invoked — that is, the supposed corporation or its members — were not misled by any misrepresentation of the person who is to be estopped. If we assume that whoever deals with a company which claims to be a corporation impliedly represents to it that it is incorporated, yet the supposed company or its members are not misled; for they are better acquainted with the facts than he can possibly be." Machen, Modern Law of Corporations, § 282.

[28] 20 HARV. L. REV. 475–476.

of this and it would be inequitable to let A. hold the stockholders to individual liability. In this first case Mr. Warren makes the unwarranted assumption that unless we preclude A. from denying the validity of the contract with the corporation he will be able to hold the associates to individual liability. Individual liability of the associates is not a necessary legal consequence of an unsuccessful attempt to incorporate.[29] To permit A. to hold the associates to

[29] The courts are divided on the question of whether the members of a defectively organized corporation can be held individually or as partners upon the contract. On principle it would seem perfectly clear that they could not be held upon a contract they never made.

"If an association assumes to enter into a contract in its corporate capacity, and the party dealing with the association contracts with it as if it were a corporation, the individual members of such association cannot be charged as parties to the contract, either severally or jointly, or as partners. This is equally true whether the association was a corporation or not, and whether the contract with the association in its corporate capacity was authorized by the legislature or prohibited by law and illegal. The fact that the parties have failed to make a binding contract, as contemplated, because they erroneously supposed that the association was a corporation, or because the agreement actually entered into was prohibited by law and invalid, would certainly not be a reason for treating them as if they had entered into a different agreement which neither of the parties contemplated. If an association undertakes to enter into a contract as a corporation, it is clear that the members of the association do not agree to be . . . bound as partners either to each other or to the party contracting with the association. It is equally clear, that the party contracting with the association does not intend to contract with its members individually. To treat the individual members of the association as parties to the contract, under these circumstances, would therefore involve not only the nullification of the contract which was actually contemplated by the parties, but the creation of a different contract, which neither of the parties intended to make.

"It seems surprising that the authorities should be conflicting upon so plain a proposition. Yet there are numerous cases in which parties have been held by the courts to be liable as partners, upon contracts which were intended to bind them as a corporate association only. In these cases the courts seem to have proceeded on a theory that, if the associates cannot be treated as a corporation, they must necessarily be held liable as partners, irrespective of the agreements actually made. Upon a similar theory, it would follow that, if a contract made on behalf of a legally incorporated company is not binding upon the corporation because in excess of the company's chartered powers, the members of the company would be chargeable individually as partners. This proposition, however, appears never to have received judicial sanction." Morawetz, Private Corporations, § 748.

Not only have courts gone astray on the proposition but some legal theorists as well. In Machen's excellent work, Modern Law of Corporations, § 293, the author takes the position that where the doctrine of *de facto* corporations is not applicable, the members of a defectively incorporated company should be held to individual liability. He says the authorities which hold that the members are not liable as partners "proceed upon the ground that the several members never intended to assume the position of co-partners and never held themselves out as occupying that relation,

individual liability gives A. a right in contract beyond that for which he contracted, and imposes a contract liability upon the stock-

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so that injustice would be done by treating them as such. But this argument, although specious, is believed to be fallacious. Although it is true that the members of the association did not intend to become partners, they did intend to engage in a joint enterprise as an associated body. Now the law knows but two forms of associations for business or trade — corporations and partnerships, and as they are not a corporation they must be a partnership." The error in this reasoning is easily demonstrable. Since, as Machen says, there are only two forms of associations for business known to the law — corporations and partnerships — if persons attempt to form a partnership but are unsuccessful in such attempt, according to his reasoning a corporation must be the result. Of course this is absurd. Again the error in this reasoning will appear by use of another test, *i. e.* whether the association was formed for a purpose of gain or profit. It is primary that to have a partnership it must be organized for purpose of profit. Suppose persons attempt to form a corporation to grade a public street but with no purpose of profit, as was done in the case of Johnson *v.* Corser, 34 Minn. 355, 25 N. W. 799, and fail in their attempt to incorporate. It is impossible to have a partnership as a result, because it lacks that essential characteristic of a partnership — organization for purpose of profit.

In 21 HARV. L. REV. 311–312, Mr. Warren puts a case where "the associates assume to act as a corporation without making any attempt to comply with any law regulating the formation of corporations. They style themselves a corporation, and adopt the forms of procedure usually followed by corporations *de jure*. A. contracts with them as a corporation. On a breach of the contract A. seeks to hold the associates to full liability, and they seek to confine A. to a remedy against the assets, if any, of the corporation.

"A contract, say the associates, is a consensual transaction. Out of a consensual transaction can arise only such obligations as the parties intended to arise. We agreed to be bound as a corporation, but we did not agree to be bound as individuals. To bind us as individuals would be to make a new contract for us. A. must hold us as a corporation, or not at all.

"But, answers A., a man's rights are not necessarily as large as his assertions. Legal incorporation, to be sure, would have shielded the associates from full liability, but they never were legally incorporated. They assumed the corporate shield without authority. What they assumed without authority must be stripped from them.

"It is childish for them to argue that their liability is bounded by their own intent. If they assumed to do an act with limited liability, and they had no authority to limit their liability, then their liability for that act is unlimited. They did not have authority to limit their liability for the act, but that did not prevent the act from being theirs. It is not their liability, but their partial exemption from liability, which fails. They stand exposed to the consequences of their own acts."

Let us restate Mr. Warren's argument, the gist of which he has embodied in syllogistic form in the immediately preceding paragraph. If we substitute for his generalized statement a statement more nearly representative of the transaction under discussion without altering the force of his syllogism, the revised statement will take this form. If the associates assumed to enter into a contract on a corporate basis, and they had no authority to contract on a corporate basis, then they are individually liable on the contract. Clearly the conclusion that they are individually liable on the

holders which they never contracted to assume. Regardless of the *de facto* requisites A. should not be allowed to hold the stockholders to individual liability.

The refusal to permit A. to hold the associates to individual liability is not to be based upon the ground that he has by consenting to contract with the corporation waived a remedy available to him,

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contract does not follow from the premises stated, for there is the possibility that there is no liability on the contract at all.

Further on in the same article Mr. Warren says: "The contention that out of a consensual transaction no obligations can arise except such as the parties intended to arise is not sound. The law frequently imposes upon the parties to a consensual transaction certain obligations not covered by their actual, or expressed intent. . . . Thus A. may sell goods to B. and may find that the law imposes upon him a warranty of their quality, although he had no intent to make such warranty. Thus A. may, without authority, assume, as agent of B., to contract with C., and may find that the law imposes upon him personally a liability under the contract.

"The agent does not intend to be bound himself at all, but, if he acts without authority, full liability for the act rests upon him. The associates intend to be bound, but with limited liability. If they are without authority to limit their liability, full liability for the act rests upon them."

Mr. Warren would have us infer that the refusal to hold the associates individually liable on the contract entered into upon a corporate basis is based upon the conception that "no obligation can arise out of a consensual transaction except such as the parties intended to arise." But such an inference is unwarranted, for in the case under discussion, while we think the associates should not be held individually liable on the contract, we believe the law should impose upon the associates "an obligation not covered by their actual or expressed intent." The associates should be held quasi-contractually for the benefits received by them. It is well to observe that the supposedly analogous cases which Mr. Warren evidently considers arguments for holding the associates individually liable on a contract entered into upon a corporate basis, are cited to show that "the law frequently imposes upon parties to a consensual transaction, certain obligations not covered by their actual or expressed intent," and that Mr. Warren cites no cases to show that the law ever substitutes in place of an intended contractual obligation a contractual obligation which both parties to the contract affirmatively intended not to assume. It is true that the law does sometimes impose upon the seller of goods a warranty of quality which the seller did not intend to make. But any words or conduct tending to show that there was an intention of the parties not to warrant will prevent the implication of warranty from arising. See Williston, Sales, § 239. It seems it would be better to cite the case to show that the associates should not be held to individual liability, for contracting on a corporate basis is manifesting an intent not to contract on a basis of individual liability and should therefore prevent the implication of an obligation, intended not to be assumed, from arising. It is also true that the law imposes an obligation not covered by his intent upon the agent who acts without authority. His liability, however, is based upon a matter entirely distinct from the contract. It is based upon an implied warranty of authority, and he should not be held liable on the contract. See Ames' criticism of § 20 of the Negotiable Instruments Law, Brannan's Negotiable Instruments Law, 26.

but rather upon the ground that he never was entitled to hold the associates to individual liability.

In the second case, where the corporation seeks to hold A. on his contract with it, is it correct to say that A., by consenting to contract with the corporation, has by necessary inference consented to avail himself on a breach of the contract of only such remedies as could be used if the associates possessed the corporate privilege, or by contracting has assumed the *de jure* existence of the corporation? A. cannot justly be held to consent to forego remedies the existence of which depends upon circumstances of which he is entirely ignorant. If the corporation is represented to A. to be competent to contract, can it be said that A., induced to enter into a contract with the corporation because of such misrepresentation, has thereby waived his right to object on the ground of such misrepresentation? For example take a parallel case: If A. enters into a contract with an infant, who represents himself to A. to be of age, clearly A. is not bound by the contract.[30] The courts have not been so confused in their thinking as to say that by consenting to enter into the contract with the infant A. has thereby consented not to avail himself of any other remedies than those he might use if the infant were of age. How does A.'s consent to contract in the one case involve a waiver of remedies not contained in the other? A.'s consent to contract with the corporation, instead of being an assent to forego any of his remedies arising from its not being a corporation, is merely a manifestation of willingness to rely upon the representation made by certain persons that he is dealing with a corporation competent to contract. If the representations are untrue he should have all the remedies open to him that follow as a consequence of such false representation. In the second case, then, A. seeks to set up a defense which he has never agreed not to use and of which he is allowed to avail himself, unless, of course, there is no such defense existing because the corporation was one *de facto* and therefore competent to contract.

If this "argument *ad hominem*" be sound, it should apply against A. no matter how defective the incorporation, even in cases where the corporation is not *de facto*. For A.'s assent to forego his remedies is not affected by the corporation's competency or incompetency

[30] That A. may avoid a contract entered into with an infant on the infant's representation that he was of age, see Williston, Sales, § 26.

to contract. The decisions, however, do not preclude one who has dealt with a corporation lacking the *de facto* requisites, from attacking the corporation's existence.[31] Mr. Warren recognizes this and says, "It is in this connection that courts make the most important application of the *de facto* conception." He thinks it is fair between the parties that a contract entered into on a corporate basis should be enforced upon the same basis, "but it is against public policy thus to allow parties to create *pro tanto* corporations at their will." Mr. Warren thinks the weight of this argument of public policy decreases as the defectiveness of incorporation decreases until we reach a point where the *de facto* requisites are present, and there the argument of public policy against the validity of the contract is not strong enough to override the argument of fairness between the parties and the contract is therefore given validity. It is to be observed that Mr. Warren thinks that public policy and fairness between the parties are opposing considerations and that public policy is against the enforcement of contracts made by a defectively organized corporation, while the consideration of fairness between the parties is in favor of their validity. This is certainly an ingenious excuse for the "argument *ad hominem*," but is it not fallacious to assume that these considerations are uniformly opposed to each other and that fairness always requires a contract entered into by A. with a defectively organized corporation to be enforced against A.? Where A. is prejudiced by relying upon the representation of the associates that they are a corporation, it is difficult to see where fairness between the parties requires that he should be held to his contract with the corporation. Suppose that A. should take out a policy of insurance with a corporation upon representations that the company was incorporated where he would be protected by a large capital stock, and suppose no articles of incorporation had been taken out or stock subscribed. Is it not absurd to say that since A. was willing to rely upon the representations that the company was an insurance corporation and to enter into a contract upon that basis, fairness demands that the corporation be allowed to hold him to his contract? Instead of standing opposed to public policy, it seems the consideration of fairness between the parties, if it is distinct from the consideration of public policy, combines with it to support the validity of a contract with a corporation *de*

[31] See note 11, *supra*.

facto and to oppose the enforcement of a contract with an association which has completely or largely failed to comply with the statute of incorporation.

4. *The stock-subscription and eminent-domain cases.*

Where there has not been dealing on a corporate basis with the *de facto* corporation, the courts regularly reach a result explainable by the unrestricted doctrine of *de facto* corporations alone; but there are two classes of cases in this group in which the *de facto* corporation does not stand so well as the corporation *de jure*. These cases are cited to show that the doctrine of *de facto* corporations breaks down when there is no basis for invoking estoppel. One class of cases is where A. takes and agrees to pay for shares of stock in a corporation to be formed, and the other is where a *de facto* corporation attempts to exercise the power of eminent domain. In the first group, if only a *de facto* corporation is formed, it cannot compel A. to take and pay for his stock, and in the second group the owner may prevent the *de facto* corporation from taking his land by condemnation.

Mr. Warren cites these cases as examples of refusals by the courts to apply the doctrine "in favor of the associates themselves, to the prejudice of a person who has not dealt with them as a corporation."[32] It is submitted that in neither case are the courts refusing to apply the doctrine of *de facto* corporations. The doctrine does not involve the idea that the corporation *de facto* is equivalent to the corporation *de jure*. The corporation *de facto* may have its charter annulled by the state upon a ground that does not obtain in the case of the *de jure* corporation, *i. e.* that of failing to comply with the statute. A man purchasing stock would have reason for preferring a corporation *de jure* to one *de facto*, even where the *de facto* doctrine is ostensibly applied without limitation. If he contracted to take shares in a corporation *de jure* he would have substantial grounds to refuse a tender of shares in a corporation *de facto*. Now a person who contracts to take shares in a corporation to be formed contracts for shares in a corporation to be formed legally, *de jure*. The courts refuse to permit the corporation to hold A. liable on his contract because the corporation has not performed a condition precedent to A.'s liability on the contract, and

[32] 20 HARV. L. REV. 472.

not because they refuse to recognize the legal existence of the corporation. This may be illustrated by supposing the case arose in a state where the *de facto* doctrine is provided for by statute.[33] Is it not clear that the *de facto* corporation in such state should not be permitted to hold A. on his contract? It is not a refusal by the courts to apply the *de facto* doctrine, but is simply an application of a well-established principle of contracts.

No corporation can condemn land unless it is expressly authorized by the statute. This power of exercising eminent domain is the highest attribute of sovereignty that the state can grant. If a statute confers upon a class of corporations the privilege of exercising this extraordinary power, the statute is properly construed as conferring that power only upon those corporations which have substantially complied with the statute of incorporation.[34] Again, it is not a refusal to apply the *de facto* doctrine but is merely interpreting the statute granting the power of eminent domain.

To summarize:

The *de facto* corporation is one which has failed to comply with the conditions precedent to incorporation prescribed by the legislature, but has complied with certain technical requisites laid down by the courts. The *de facto* doctrine does not mean that the *de facto* corporation is just as good legally as the *de jure* corporation except as against the state. The *de facto* doctrine consists, rather, in holding the corporation *de facto* equivalent to the corporation *de jure* except for the legal differences that necessarily arise from

[33] California, North Dakota, South Dakota, and perhaps other states provide for the *de facto* doctrine by statute. 20 HARV. L. REV. 468, note 20.

[34] "The power of condemning land for public purposes belongs to the state alone. No person or corporation, whether it be a legally formed corporation or not, can exercise this power unless expressly authorized to do so. Hence, if a statute conferring the power to condemn land is intended by the legislature to apply only to legally formed corporations, a corporation which has not been legally formed can derive no authority from it; and an attempt on the part of such a company to exercise the power will have no greater validity than if the statute had never been passed. A statute purporting to confer the power of condemning land upon railroad companies incorporated under the laws of the state, is clearly intended to apply to legally incorporated companies only. It is not intended to apply to self-constituted corporations having no legal right to exist; and there seems to be no reason for applying a different rule in favor of companies which undertook to become incorporated according to law, but failed to comply with the forms prescribed by law as conditions precedent to a legal incorporation." Morawetz, Private Corporations, § 768.

the fact that the corporation *de facto* may have its charter annulled by the state for failing to incorporate according to statutory requirements. The doctrine is based upon reason and justice and in the form stated above, though it may discord with many of the *opinions* of the courts, harmonizes with practically all of the American *decisions*, and furnishes a clear-cut and adequate explanation of them.

On the other hand, the contrary view that the doctrine of *de facto* corporations is to be used only in conjunction with other legal principles or when the exigencies of the particular case demand it, is unsatisfactory. The necessity to search for and to find in each case some "extenuating circumstance" to justify the doctrine's application is cumbersome and superfluous. Furthermore, this view which limits the *de facto* doctrine is not sustained by the arguments used to support it. These arguments are either *per se* indefensible, or support rather than oppose the unrestricted application of the *de facto* doctrine.

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